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**A DIFFERENT PERSPECTIVE ON THE DEBATE BETWEEN  
NONPROFIT AND FOR-PROFIT MICROFINANCE  
ORGANIZATIONS**

by

**Hane E. de Oliveira Crevelari**

**Thesis submitted in partial fulfillment  
of the requirements for the degree**

of

**Department Honors**

in

**Economics and International Business  
in the Department of Economics & Finance and Management**

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**UTAH STATE UNIVERSITY  
Logan, UT**

**Spring 2017**

# **A DIFFERENT PERSPECTIVE ON THE DEBATE BETWEEN NONPROFIT AND FOR-PROFIT MICROFINANCE ORGANIZATIONS**

**Hane de Oliveira Crevelari**

A capstone internship thesis for business honors

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## **ABSTRACT**

Microfinance for-profit organizations flooded the market in the early 2000's when microcredit demonstrated profitability. Ever since, an intense debate arose contesting the morality of profiting from the poor. Many for-profit microfinance institutions were accused of predatory lending through high interest rates and aggressive marketing and payment collection. In this paper, I examine the validity of the arguments for and against for-profits by extensively comparing the different target audiences of the charity sector and the private sector and the main arguments of each side. I conclude that, although the ability to serve the poor is compromised by profit motives, for-profit microfinance organizations are serving a different market - and a much needed one - than nonprofits. Therefore, for-profits serve a function that, as of right now, nonprofits are not able to.



*"Para meus queridos pais."*

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## INTRODUCTION

The stereotypical debate between nonprofits and for-profits microfinance organizations seems simple: Nonprofits are 'the good guys,' while for-profit are the 'bad guys.' 'The good guys' are the ones with good intentions, seeking to help the poor. 'The bad guys,' on the other hand, exploit the poor in order to increase profitability. The debate in depth, however, is not that simple, nor are the stereotypical assumptions correct.

On one side, for-profit organizations have been accused of exploiting the poor by irresponsibly increasing the number of clients or charging exorbitant interest rates on loans in order to maximize profits. According to Muhammad Yunus, the presiding economics department head of Chittagong University and founding father of the traditional microfinance model, the empathy that first jump-started the microcredit movement and its purpose has now been compromised by profit motives.<sup>1</sup> On the other side, the nonprofit sector has been accused of being inefficient and incapable of making a large-scale social impact in a reasonable amount of time due to the stigmatization of business practices. The founder of SKS Microfinance, Vikram Akula, argues that after working for Deccan Development Society's microfinance program, he realized the limitation of nonprofits' ability to acquire the funds needed to help the poor today.<sup>2</sup>

Despite the similarities and economic and social tradeoffs, microfinance

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<sup>1</sup> Yunus, Muhammad. "Sacrificing Microcredit for Megaprofits." *Nytimes.com*. January 14, 2011. <http://www.nytimes.com/2011/01/15/opinion/15yunus.html> (accessed February 14, 2017).

<sup>2</sup> Conan, Neal, interview by Vikram Akula. "Helping the Poor for Profit." *Talk of the Nation*. (November 25, 2010).

nonprofits and for-profits appear to be serving distinct audiences. While nonprofit organizations focus on the poorest of the poor as well as minimizing the risk of default, for-profits focus on the unregistered, the disadvantaged, and the marginalized all while maximizing revenue.<sup>3</sup> Their microfinance model might be analogous, but their end goal differentiates who they target and serve. This paper argues that neither nonprofits nor for-profits can solve all of the world's poverty. Both are, however, complementary and much needed in order to serve two important, and often ignored, markets.

## **BACKGROUND**

In the middle of the 1970's, Muhammad Yunus was one of the first to develop an innovative way to combat poverty in Bangladesh by becoming the "banker to the poor." Using his personal funds, Yunus started providing basic financing services to individuals living under the poverty line with the belief that access to credit and financial principles, not charity, were the key to alleviate poverty. By providing small loans to individuals that would normally be rejected by traditional banks, Yunus was able to incentivize entrepreneurship in Bangladesh and help the poor help themselves. His financial model, known as microcredit, was so successful that in 1983 he established the nonprofit organization Grameen Bank. Soon after, microcredit was adopted and implemented in over 100 countries, especially in

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<sup>3</sup> Vento, Mario La Torre and Gianfranco A. "Banks in the Microfinance Market." In *Frontier of Banks in a Global Economy*, edited by Phipip Molyneux, 131-147. New York, NY: Palgrave Macmillan.

underdeveloped and developing regions.<sup>4</sup> In fact, the microcredit industry grew with such intensity that the industry evolved to be known as microfinance instead, and by 2014 over 130 million people were granted access to financial services.<sup>5</sup>

Microcredit is the supply of “small loans, often without traditional guarantees, aimed at improving the life of clients and their families or at sustaining small-scale economic activities.”<sup>6</sup> Ultimately, the purpose of microcredit was to promote economic development and job creation by opening up opportunities for the poor to become self-sufficient. Initially, these goals were mostly addressed by nonprofits. The popularity of credit, however, came from the idea that the poor are not victims, but instead they are “resilient and creative entrepreneurs and value-conscious consumers.”<sup>7</sup> This mentality, preached by C.K. Prahalad in his book *The Fortune at the Bottom of the Pyramid*, shifted the way many businesses and investors viewed lower-income individuals. Ever since, the idea of microfinance has spread, and, in the last decade alone, investors have been pouring millions in microfinance investment vehicle (MIVs) funds, with over \$11 billion in assets being managed as of 2010.<sup>8</sup> The difference between microfinance and microcredit is

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<sup>4</sup> Nobel Prize. *Muhammad Yunus - Biographical*. Edited by Karl Grandin. 2007. [https://www.nobelprize.org/nobel\\_prizes/peace/laureates/2006/yunus-bio.html](https://www.nobelprize.org/nobel_prizes/peace/laureates/2006/yunus-bio.html) (accessed February 12, 2017).

<sup>5</sup> International Finance corporation. *IFC.org*. [http://www.ifc.org/wps/wcm/connect/Industry\\_EXT\\_Content/IFC\\_External\\_Corporate\\_Site/Industries/Financial+Markets/MSME+Finance/Microfinance/](http://www.ifc.org/wps/wcm/connect/Industry_EXT_Content/IFC_External_Corporate_Site/Industries/Financial+Markets/MSME+Finance/Microfinance/) (accessed February 12, 2017).

<sup>6</sup> Vento, Mario La Torre and Gianfranco A. "Banks in the Microfinance Market." In *Frontier of Banks in a Global Economy*, edited by Philip Molyneux, 131-147. New York, NY: Palgrave Macmillan.

<sup>7</sup> Prahalad, C.K. *The Fortune at the Bottom of the Pyramid: Eradicating Poverty Through Profits*. Edited by Patti Guerrieri. Upper Saddle River, NJ: Wharton School Publishing, 2005.

<sup>8</sup> Consultative Group to Assist the Poor/The World Bank. "Microfinance Investment Vehicles Disclosure Guidelines." *Cgap.org*. 2010. <https://www.cgap.org/sites/default/files/CGAP-Consensus->

simple: microfinance offers additional financial services beyond loans, while microcredit offers only the latter. However, both words are often used interchangeably.

## THE DIFFERENT MARKETS

Several studies have been conducted that demonstrate how commercial microfinance is serving a different market than nonprofits.<sup>9</sup> *The U.N. World Development Reports* divide the world's population into three tiers by income adjusted for purchasing power parity. Figure ones shows that nonprofits usually focus on the bottom of the pyramid (4), while for-profits microfinance Institutions (MFIs) tend to focus between the upper bottom (4) and the lower middle (2 and 3).<sup>10</sup>

Furthermore, Mario Vento and Gianfranco differentiate the target audience of NGOs and for-profit MFIs even further in *Frontier of Banks in a Global Economy*.<sup>11</sup> They argue that nonprofits serve the poorest of the poor, while for-profits serve the

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Guidelines-Microfinance-Investment-Vehicle-Disclosure-Guidelines-Sep-2010.pdf (accessed February 14, 2017).

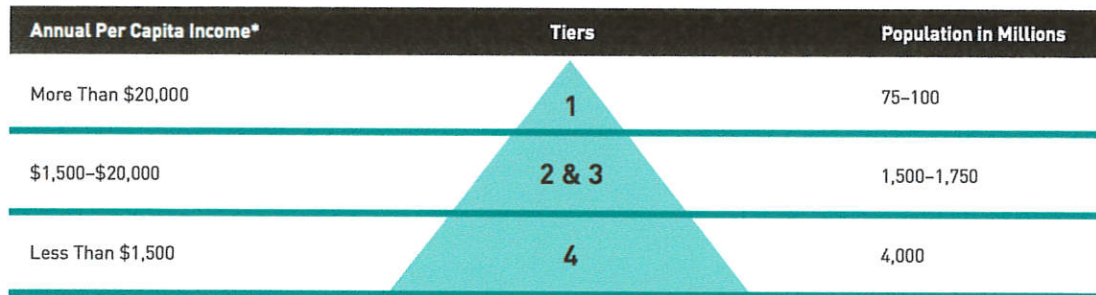
<sup>9</sup> Lowery, Curtis A. "Intention versus Impact: Comparing Interest Rates Charged by Non-profit Organizations and Commercial Banks in Latin American Microfinance Industry." Order No. 10257984, San Diego State University, 2016.  
<http://dist.lib.usu.edu/login?url=http://search.proquest.com.dist.lib.usu.edu/docview/1877957586?accountid=14761> (accessed April 20, 2017)

<sup>10</sup> Abrar, A., and A. Y. Javid. "Commercialization and mission drift: A cross country evidence on transformation of microfinance industry." *International Journal of Trade, Economics and Finance*. 2014.

<sup>11</sup> Vento, Mario La Torre and Gianfranco A. "Banks in the Microfinance Market." In *Frontier of Banks in a Global Economy*, edited by Philip Molyneux, 131-147. New York, NY: Palgrave Macmillan.

unregistered, the disadvantaged, and the marginalized.<sup>12</sup>

**Figure 1. The World Economic Pyramid** <sup>13</sup>



\* Based on purchasing power parity in U.S.\$  
Source: U.N. World Development Reports

### **The Poorest of the Poor and the Poor**

The poorest of the poor and the poor are characterized by those with an annual income of US\$1,500 or less, according to the world economic pyramid. The poorest of the poor category includes individuals facing self-exclusion, which are usually a result of “an individual’s feeling of inadequacy with regards to the conditions required by financial intermediaries.”<sup>14</sup> The poor category is defined by access exclusion, which usually happens due to the “failure of potential clients to meet creditworthiness requirements.”<sup>15</sup> Those two markets represent the conventional target audience of the traditional microfinance sector, or microcredit sector, which was purely nonprofits at first.

<sup>12</sup> IBID.

<sup>13</sup> Prahalad, C.K. and Stuart L. Hart. “The Fortune at the Bottom of the Pyramid.” *Strategy+Business*. 2002. <https://people.eecs.berkeley.edu/~brewer/ict4b/Fortune-BoP.pdf> (accessed April 20, 2017).

<sup>14</sup> IBID.

<sup>15</sup> IBID.



## **The Unregistered, the Disadvantaged, and the Marginalized**

The for-profit microfinance institutions, on the other hand, have a very distinct target audience that also suffers from financial exclusion, but for different reasons. They are known as the unregistered, the disadvantaged and the marginalized. First, the unregistered are defined as those who suffer social and political exclusion - individuals excluded from the sociopolitical system, such as immigrants.<sup>16</sup> Second, the disadvantaged are referred to as those who cannot bear the cost or meet the requirements imposed by traditional financial institutions, suffering conditional exclusion.<sup>17</sup> Finally, the marginalized are conditioned to marketing exclusion, which happens to low-value targets, being *literally* marginalized by traditional banks.<sup>18</sup> Until nonprofits move beyond the poorest of the poor, for-profits MIFs will keep serving a much needed market (3 and 4). Although some for-profits might be exploiting their target market, they still serve a function that nonprofits are currently failing at.

### **THE TECHNICALITIES**

In order to understand the controversies between microfinance for-profits and nonprofits, one must first understand the difference between the two and the microloan model.

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<sup>16</sup> IBID.

<sup>17</sup> IBID.

<sup>18</sup> IBID.

## What are Nonprofits

There are 29 types of nonprofits, ranging from 501(c)(1) to 501(c)(29); however, Microfinance organizations can only register under the Internal Revenue Service (IRS) Code Section 501(c)(3) - groups registered as charitable organizations, being tax-exempt. According to the IRS, these kind of organizations “must be organized and operated exclusively for exempt purposes [...] and none of its earnings may inure to any private shareholder or individual.”<sup>19</sup> They exist to serve and provide a benefit to the public, whether educational, charitable, scientific, or literary, having no profit motives.

### *Types of Charities*

Within section 501(c)(3), there are two types of charitable organizations: private foundations and public charities.<sup>20</sup> According to the IRS, private foundations are defined as all organizations under section 501(c)(3), with the exception of “organizations referred to in section 509(A)(1), (2), (3), or (4)”<sup>21</sup> - which are public charities. Examples of public charities include museums, universities, churches, and hospitals. The two main differences between the two types of nonprofits are their source of funding and primary activity. Private charities generally have one major

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<sup>19</sup> IRS. *Application for Recognition of Exemption*. January 05, 2017. <https://www.irs.gov/charities-non-profits/application-for-recognition-of-exemption> (accessed February 26, 2017).

<sup>20</sup> IRS. *Exemption Requirements - 501(c)(3) Organizations*. January 26, 2017. <https://www.irs.gov/charities-non-profits/charitable-organizations/exemption-requirements-section-501-c-3-organizations> (accessed February 26, 2017).

<sup>21</sup> IRS. *Public Charities*. January 05, 2017. <https://www.irs.gov/charities-non-profits/charitable-organizations/public-charities> (accessed February 26, 2017).

source of funding, usually donations, which are used to provide grants to individuals or other organizations. On the other hand, public charities have many sources of funding, constantly fundraising with a focus on direct operations. Microfinance organizations may fall under either private foundation or public charity.

### *Generating Revenue*

A common mistake is to assume nonprofits are only dependent on donations to survive. Although securing and sustaining funding is essential to the model of most nonprofits, they may also generate money from their activities. The money generated may then be used for a variety of purposes, such as paying expenses or investing further in the organization. As long as revenues are used to fulfill the objective of the organization, there is no tax liability.<sup>22</sup>

A perfect example of a nonprofit that is effective at generating revenue and sustaining itself is Kiva, an online platform that facilitates individuals from developed countries to fund small- and medium-sized businesses in developing and underdeveloped countries through microlending.<sup>23</sup> Kiva's model is as follows: individuals around the globe lend their money at a 0-percent interest rate through Kiva's website. The money is managed by MFIs that *do* charge interest rates to the borrowers, collecting the interest as income. The interest rate charged is used to cover some of Kiva's website costs, management costs, and other expenses. Since

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<sup>22</sup> IRS. *Application for Recognition of Exemption*. January 05, 2017. <https://www.irs.gov/charities-non-profits/application-for-recognition-of-exemption> (accessed February 26, 2017).

<sup>23</sup> Kiva. *Kiva*. <https://www.kiva.org/> (accessed March 01, 2017).

the amount of money borrowed is usually as small as US\$25, the impact of default is virtually nonexistent. In addition, whether lenders are providing funds out of the goodness of their hearts or to write it off on their taxes, the risk of default is likely not considered. In other words, Kiva places the risk of default on the lender's shoulders, leaving the MFIs with "access to free, flexible, and very forgiving debt capital."<sup>24</sup>

### **What are For-Profits**

The IRS divides business entities in six different forms: sole proprietorship, partnerships, cooperatives, limited liability companies (LLC), and corporations - the former being the simplest and most basic type of business and the latter the most complex.<sup>25</sup> All of them generally have the same goal of maximizing return on investment; however, each type of structure differs from each other in legal and tax terms. The details of each business structure need not be covered for the purpose of this paper.

#### *B Corps and Benefit Corporations*

The rise of corporate social responsibility gave birth to two relatively new types of for-profit organizations: B Corps and Benefits Corporations. Although the two terms are usually used synonymously, they are slightly different from each

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<sup>24</sup> Saloner, Bethany Coates and Garth. *The Profit in Nonprofit*. 2009.

[https://ssir.org/articles/entry/the\\_profit\\_in\\_nonprofit](https://ssir.org/articles/entry/the_profit_in_nonprofit) (accessed March 01, 2017).

<sup>25</sup> IRS. *Business Structures*. January 10, 2017. <https://www.irs.gov/businesses/small-businesses-self-employed/business-structures> (accessed March 01, 2017).

other. All forms of businesses, international or national, can become a B Corp by acquiring a certificate issued by a third party organization. The third party is responsible for laying out rigorous “social and environmental performance, accountability, and transparency” standards that companies desiring to become a B Corp must meet.<sup>26</sup>

On the other hand, any national company can become a Benefit Corporation. While their main purpose may overlap, Benefit Corporations mainly differ from B Corps in how they come to exist. To become a Benefit Corporation a company needs to be authorized by the state. Currently, only 22 states have passed legislation for Benefit corporations.<sup>27</sup> Microfinance companies can be registered both as Benefit Corporations and B Corps. In addition, microfinance institutions can also be registered as a corporation with traditional corporate governance.<sup>28</sup> However, many argue that conventional corporate governance concepts is not the best method to address issues specific to microfinance corporations.<sup>29</sup>

### **Mixing It Up**

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<sup>26</sup> Cullinane, Jeff. *What is a B Corp? What is a Benefit Corporation? What's the Difference?* March 4, 2014. <http://cullinanelaw.com/what-is-a-b-corp-what-is-a-benefit-corporation/> (accessed March 02, 2017).

<sup>27</sup> B-Lab. *How to Become a Benefit Corporation*. <http://benefitcorp.net/businesses/how-become-benefit-corporation> (accessed March 2, 2017); The states that have passed legislation relating to Benefit Corporations are Arizona, Arkansas, California, Colorado, Delaware, Florida, Hawaii, Illinois, Louisiana, Maryland, Massachusetts, Nebraska, Nevada, New Jersey, New York, Oregon, Pennsylvania, Rhode Island, South Carolina, Vermont, Virginia and Washington D.C.

<sup>28</sup> Martinez-Lopez, Carmen L. “Corporate Governance in Microfinance Enterprises: A Conditional Matrix Study from Spain and Latin America.” *Journal of International Management Studies*. October 2014.

<sup>29</sup> Varottil, Umakanth. “Microfinance and the Corporate Governance Conundrum.” *Berkeley Business Law Journal*. January 2016. <http://scholarship.law.berkeley.edu/cgi/viewcontent.cgi?article=1097&context=bblj> (accessed April 24, 2017).

Many large companies also implement microfinance as a sector of their corporate social responsibility department - a nonprofit within a for-profit. Danper, a Peruvian agricultural company, implemented the program Sembrando Futuro, where its manufacturing workers are encouraged to apply for a loan through the company. Prospective participants go through a selection process and about 25 to 50 participants become finalists.<sup>30</sup> The finalists are then trained by students from Utah State University to gain a better understanding of basic business principles for six months. At the end of the training, participants present their business plan and are then again selected or rejected as a loan recipient. If selected, the receivers are then monitored and offered consulting services to make sure his or her business remains profitable until the loan is completely paid off. The capital for the loans does not come from the company itself. It is instead donated by Utah State University and the Wasatch Group.<sup>31</sup>

### **Informal, Semi-formal, and Formal Institutions**

Within the category of nonprofit and for-profit, one can go further and distinguish microfinance institutions as informal, semi-formal, or formal. First, informal institutions are not *actually* institutions. They are microfinance activities that take place voluntarily by “self-help groups, credit associations, families, and

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<sup>30</sup> The company will accept an unlimited amount of applicants; however, there is generally only funds available for 50 selections.

<sup>31</sup> Crevelari, Hane. *Peru Small Enterprise Education Development Program Intern*. September 12, 2017 to December 5, 2017.

individual money lenders.”<sup>32</sup> Because of the nature of informal institutions, they cannot be regulated.

Semi-formal institutions, also known as microfinance financial intermediaries (MFFIs), are the most traditional form of microfinance, being simply a microcredit organization. They are registered institutions subjected to financial regulations, but are not treated as a bank since their service is credit-only. Examples of MFFIs include “financial NGOs, financial cooperatives, credit unions, and postal saving banks.”<sup>33</sup>

Formal institutions fall within three subcategories: microfinance banks (MFBs), microfinance oriented banks (MFOBs), and microfinance sensitive banks (MFSBs). They are all subject to banking regulation and are able to offer any traditional banking services including savings and checking accounts and credit. Microfinance banks include banks that fully dedicate themselves to microfinance services. They are scarce compared to other types of banks since most institutions serve a larger array of clientele. Microfinance oriented banks includes small and local banks with experience in financing medium, small, and micro enterprises. They are usually deeply rooted within a community. Microfinance sensitive banks, on the other hand, include all of the other banks and intermediaries that use microfinance as an opportunity to profit. They are usually larger banks that enter the microfinance sector by creating a specialized division and downscaling their

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<sup>32</sup> Vento, Mario La Torre and Gianfranco A. “Banks in the Microfinance Market.” In *Frontier of Banks in a Global Economy*, edited by Philip Molyneux, 131-147. New York, NY: Palgrave Macmillan.

<sup>33</sup> IBID.

traditional activities.<sup>34</sup>

### **Basics of Microfinance**

After understanding the differences and similarities between nonprofits, for-profits, and other forms of microfinance institutions, digging into the definition of microfinance and its model is the next step before diving into its controversies.

In 2016 there were two billion people who lacked access to formal financial services.<sup>35</sup> Microfinance organizations, whether for-profit or nonprofit, offered financial services for the poor and low-income communities for the first time, mainly through small loans.<sup>36</sup> According to Vision Fund International, the average loan size is US\$552, varying greatly among different regions of the world.<sup>37</sup> Some provide management or financial training, such as personal budgeting and marketing, checking and savings accounts, payment services, technical assistance, and even insurance coverage, such as options insurance, to their clients. The idea behind microfinance is that the poor are able to work their way out of the poverty cycle through entrepreneurship and by obtaining the initial capital necessary to start a business.<sup>38</sup>

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<sup>34</sup> IBID.

<sup>35</sup> Pearce, Douglas. "2 Billion: Number of Adults Worldwide Without Access to Formal Financial Services." *The World Bank*. March 10, 2016. <http://www.worldbank.org/en/news/video/2016/03/10/2-billion-number-of-adults-worldwide-without-access-to-formal-financial-services> (accessed March 7, 2017).

<sup>36</sup> Holbrook, Alice. "Microfinance Institutions Balance Personal Loans with Sustainable Business Model." *NerdWallet.com*. January 8, 2015. <https://www.nerdwallet.com/blog/loans/microfinance-institutions-personal-loans/> (accessed March 2, 2017).

<sup>37</sup> Vision Fund International. *Average Loan Size*. December 31, 2016. <http://www.visionfund.org/2127/average-loan-size/impact/> (accessed March 2, 2017).

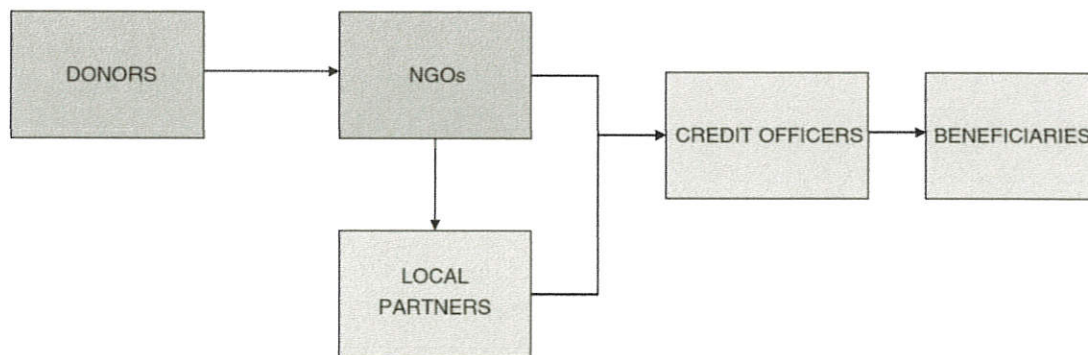
<sup>38</sup> Canales, Rodrigo, Karlan, Dean and Tony Sheldon interview by Yale School of Management. "What are the Realities of Microfinance?" *Yale Insights*. February 2, 2013. <http://insights.som.yale.edu/>



## *Funds*

The funding necessary for microfinance institutions (usually nonprofits) to operate traditionally came from donations.<sup>39</sup> The most common and popular type of donors include governmental organizations, corporations, and supranational organizations.<sup>40</sup> The part of the capital donated to non-governmental organizations (NGO's) is then transferred to a local partner or directly to credit officers. The direct officers are then responsible for managing the distribution of the loan to the beneficiaries as well as collecting the loan payments.<sup>41</sup> The standard microfinance funding structure can be seen in Figure 2 below.

Figure 2. The standard microcredit structure <sup>42</sup>



Modern microfinance institutions (usually for-profits) however, rely on

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insights/what-are-the-realities-of-microfinance (accessed March 5, 2017).

<sup>39</sup> Vento, Mario La Torre and Gianfranco A. "Banks in the Microfinance Market." In *Frontier of Banks in a Global Economy*, edited by Philip Molyneux, 131-147. New York, NY: Palgrave Macmillan.

<sup>40</sup> IBID

<sup>41</sup> IBID.

<sup>42</sup> Vento, Mario La Torre and Gianfranco A. "Banks in the Microfinance Market." In *Frontier of Banks in a Global Economy*, edited by Philip Molyneux, 131-147. New York, NY: Palgrave Macmillan.

investments as their main source of funds.<sup>43</sup> The resources usually come from other companies, bond issues, and microfinance investment funds, such as mutual funds.<sup>44</sup> In addition, for-profit microfinance institutions will often be directly involved with the loan process.

### *Interest Rates*

Interest rates, simply known as the cost of borrowing or the price paid for a loan, are a characteristic of microloans just as traditional bank loans. For nonprofits, interest rates are a way to offset the risk of default as well as provide cash flow for expenses incurred by the organization. For-profit microfinance organizations, on the other hand, generally see interest rates as a profit-generator and a risk-adjustment tool.

According to the Consultative Group to Assist the Poor (CGAP), the average interest rate for microfinance organizations worldwide was 35 percent in 2008, with dramatic variation around the globe.<sup>45</sup> As more competitors entered the market and the cost of funds decreased, interest rates have also decreased, although they are still generally higher than traditional banks.<sup>46</sup>

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<sup>43</sup> Chakravarty, S., and Pylypiv, M. I. "The Role of Subsidization and Organizational Status on Microfinance Borrower Repayment Rates." *World Development*, 66, 737-748.

<sup>44</sup> IBID.

<sup>45</sup> Kneiding, Christopher and Richard Rosenberg. "Variations in Microcredit Interest Rates." *Consulting Group to Assist the Poor*. July 1, 2008. <http://www.cgap.org/publications/variations-microcredit-interest-rates> (accessed March 5, 2017).

<sup>46</sup> Asian Development Bank. *Impact of Restrictions on Interest Rates in Microfinance*. September 2016. <https://www.adb.org/sites/default/files/publication/200141/sdwp-045.pdf> (accessed March 5, 2017).

## THE DEBATE IN DEPTH

The traditional microfinance industry emerged as a non-profit sector. As the popularity of microfinance grew and a profit potential was identified, the sector transformed and became known as the modern microfinance sector - a sector with a combination of informal, semi-formal, and formal microfinance institutions. Because of the moral righteousness motive that first started the nonprofit microfinance movement, the participation of for-profit companies in the sector faced criticism. An extended debate between nonprofits and for-profits deepened between 2007 and 2010 after the Banco Compartamos, a Mexican microfinance bank, and SKS Microfinance, an Indian microlender, successfully conducted initial public offerings, being valued at billions of dollars and becoming commercial giant operations.<sup>47</sup> The fast growth of Compartamos and SKS made a lot of people raise their eyebrows and point fingers at the for-profit microfinance organizations for exploiting the poor, while for-profits pointed a finger back, bringing up all the limitations of nonprofits.

### Opponents

Opponents of for-profit microfinance institutions argue that microfinance should be handled only by nonprofits to avoid the greed of the capitalistic mindset that undermines empathy. They point out (1) the difficulty of keeping the social

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<sup>47</sup> Bloomberg Businessweek. "Online Extra: Yunus Blasts Compartamos." *Bloomberg*. December 12, 2007. <https://www.bloomberg.com/news/articles/2007-12-12/online-extra-yunus-blasts-compartamos> (accessed March 20, 2017).

mission, (2) the tendency of imprudent lending and irresponsible borrowing, and (3) the immorality of profiting from the poor.

### *Keeping the Social Mission*

Many of the for-profit MFIs today were first nonprofits.<sup>48</sup> The reasoning behind their transformation is often explained by the need of capital growth in order to respond promptly to the high demand of people that still lack access to financial services.<sup>49</sup> However, companies' social mission of poverty alleviation is often replaced with maximizing shareholders value, which might directly affect beneficiaries.<sup>50</sup> The replacement of a company's social mission with profit motives does not necessary leads to negative impacts for its clients; it only creates valid tradeoffs that should be taken into consideration. On one hand, for-profits may charge higher interest rates. However, those interest rates are only high to the extent that they run more efficiently and successfully. That means more credit can be offered to more people, thus having a larger reach than nonprofits. On the other hand, nonprofits are likely to have lower borrowing costs since interest rates as well as risk are subsidized by taxpayers. In other words, the lower the interest rate, the less the financial burden for beneficiaries.

The problem of maintaining the social mission comes first from the

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<sup>48</sup> Rhyne, Elisabeth. "Keeping the Mission: When Nonprofits become For-Profits." *The Huffington Post*. August 9, 2010. [http://www.huffingtonpost.com/elisabeth-rhyne/microfinance-keeping-the\\_b\\_675813.html](http://www.huffingtonpost.com/elisabeth-rhyne/microfinance-keeping-the_b_675813.html) (accessed April 3, 2017).

<sup>49</sup> IBID.

<sup>50</sup> Vento, Mario La Torre and Gianfranco A. "Banks in the Microfinance Market." In *Frontier of Banks in a Global Economy*, edited by Phillip Molyneux, 131-147. New York, NY: Palgrave Macmillan.

sustainability versus outreach problem. Sustainability, in this case, refers to self-sufficiency and the ability to cover the company's costs. Outreach, on the other hand, has two definitions: the ability to reach the most amount of clients (breadth) or the ability to reach the lowest level of poverty (depth). The interaction between sustainability and outreach is dichotomous. In other words, when a MFI company decides to shift the cost of increased expenses to customers, the breadth and/or depth of outreach is affected. This problem is justifiable as long as companies aim at maintaining a balance. Opponents argue, however, that often sustainability is not an issue but an excuse to generate large profits and achieve the self-interested motives of shareholders. Take SKS as an example: Although Vikram Akula's justification to making SKS public aligned with the company's mission of reaching millions of families that needs financial services, he has been accused of wanting to keep control of trust funds and SKS after its public offering due to political interests.<sup>51</sup>

### *Imprudent Lending and Irresponsible Borrowing*

The second argument against for-profits microfinance is that profit motives lead to imprudent lending. That means for-profits have incentives to keep interest rates high as well as provide loans to the most amount of people in order to maximize profits.<sup>52</sup> These two actions, critics argue, impose serious risks to both the provider and the receiver – the poor see themselves in debt traps, while the

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<sup>51</sup> Strom, Stephanie and Vikas Bajaj. "Rich I.P.O. Brings Controversy to SKS Microfinance." *The New York Times*. July 29, 2010. [http://www.nytimes.com/2010/07/30/business/30micro.html?\\_r=1&scp=1&sq=unitus&st=cse](http://www.nytimes.com/2010/07/30/business/30micro.html?_r=1&scp=1&sq=unitus&st=cse) (accessed April 3, 2017).

<sup>52</sup> Kazmin, Amy. "Microfiance: Making a Profit from Loans to Poor Carrie Risks." *Financial Times*. June 15, 2011. <https://www.ft.com/content/7f04461c-964c-11e0-afc5-00144feab49a> (April 3, 2017).

organization exposes itself to financial risks.

It is not uncommon to see an annual percentage rate (APR) in microfinance sector at around 40 percent, reaching as high as 115 percent depending on the region.<sup>53</sup> Banco Compartamos, for example, charges between 70 to 100 percent APR.<sup>54</sup> The high interest rates are the root of a worse problem: debt traps. Debt traps, which are usually linked to loan sharks and payday loans, happen when a beneficiary falls into a circle-of-debt, having to borrow more in order to pay older loans.<sup>55</sup> The issue came to light in 2010, after over 200 people committed suicide in Andhra Pradesh, India.<sup>56</sup> The mass suicide was blamed on microfinance organizations, accused of generating overindebtedness, flooding the microfinance sector, and making use of abusive tactics for payment collection by the state, leading the state to encourage borrowers to stop paying the intermediaries.<sup>57</sup>

Debt traps usually come from irresponsible borrowing. Two factors encourage irresponsible borrowing: easy access to credit and lack of financial

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<sup>53</sup> Lowery, Curtis A. "Intention versus Impact: Comparing Interest Rates Charged by Non-profit Organizations and Commercial Banks in Latin American Microfinance Industry." Order No. 10257984, San Diego State University, 2016.

<http://dist.lib.usu.edu/login?url=http://search.proquest.com/dist.lib.usu.edu/docview/1877957586?accountid=14761> (accessed April 5, 2017).

<sup>54</sup> "Poor People, Rich Returns." *The Economist*. March 15, 2008. <http://www.economist.com/node/11376809> (accessed April 17, 2017).

<sup>55</sup> "Debt Trap!" *The Economist*. January 25, 2001. <http://www.economist.com/node/488864> (accessed April 17, 2017).

<sup>56</sup> "Hundreds of Suicides in India Linked to Microfinance Organizations." *Business Insider*. February 24, 2012. <http://www.businessinsider.com/hundreds-of-suicides-in-india-linked-to-microfinance-organizations-2012-2> (accessed April 17, 2017).

<sup>57</sup> IBID.

knowledge.<sup>58</sup> First, when individuals are exposed to easy access to credit, they are able to borrow from many institutions at once, having an incentive to do so.<sup>59</sup> Second, irresponsible borrowing is also caused by the lack of financial education necessary to make better decisions.<sup>60</sup> Not knowing any better (nor having access to resources that could improve one's financial knowledge) combined with easy access to capital promote an environment favorable to over-indebtedness to take place.

Yunis Muhammad, being completely against for-profits MFIs, believes that:

“[t]here are serious practical problems with treating microcredit as an ordinary profit-maximizing business. Instead of creating wholesale funds dedicated to lending money to microfinance institutions, as Bangladesh has done, these commercial organizations raise larger sums in volatile international financial markets, and then transmit financial risks to the poor.”<sup>61</sup>

He blames over-indebtedness on for-profits, and argues that by transmitting the

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<sup>58</sup> Schicks, Jessica and Richards Rosenberg. “Too Much Credit? An Survey of the Evidence on Over-indebtedness.” *CGAP*. September 20011. <https://www.cgap.org/sites/default/files/CGAP-Occasional-Paper-Too-Much-Microcredit-A-Survey-of-the-Evidence-on-Overindebtedness-Sep-2011.pdf> (accessed April 17, 2017).

<sup>59</sup> Schicks, Jessica and Richards Rosenberg. “Too Much Credit? An Survey of the Evidence on Over-indebtedness.” *CGAP*. September 20011. <https://www.cgap.org/sites/default/files/CGAP-Occasional-Paper-Too-Much-Microcredit-A-Survey-of-the-Evidence-on-Overindebtedness-Sep-2011.pdf> (accessed April 17, 2017).

<sup>60</sup> Khandker, Shahidur R. and Hussain A. Samad. “Are Microcredit Participants in Bangladesh Trapped in Poverty and Debt?” *The World Bank*. April 2013. <https://openknowledge.worldbank.org/bitstream/handle/10986/13125/wps6404.pdf?sequence=1> (accessed April 24, 2017).

<sup>61</sup> Yunus, Muhammad. “Sacrificing Microfinance for Megaprofits.” *The New York Times*. January 14, 2017. <http://www.nytimes.com/2011/01/15/opinion/15yunus.html> (accessed April 17, 2017).



financial risk to the poor while engaging in aggressive marketing, for-profits are creating a financial bubble similar to the 2009 financial crisis, making the poor even poorer.<sup>62</sup>

### *The Moral Dilemma*

There is also the moral dilemma that faces for-profit organizations: is it ethical to profit from the poor? Critics of for-profits argue no. Their argument often comes from the basis that intentions matter, not outcomes, which is one of the fundamental principle of Immanuel Kant, a German philosopher in the 1700's and a central figure in modern philosophy.<sup>63</sup> Particularly, it is morally wrong to profit from the poor, no matter if the poor are actually benefiting from it or not. The motives behind it is what makes it immoral. The moral debate is extended to all kinds of for-profits, but it is especially highlights for-profit MFIs because of the perceived idea that the poor are more vulnerable than other people.

### **Proponents**

In a different light, proponents of for-profit microfinance institutions do not necessarily argue against the existence of nonprofits, rather, they argue that for-profits provide a more efficient allocation of resources. They point out (1) competition leads to innovation, efficiency, and lower rates, (2) the ability to reach a larger population, and (3) the morality of outcomes.

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<sup>62</sup> IBID.

<sup>63</sup> Sandel, Michael J. "Justice: What is the Right Thing to Do?" New York: Farrar, Straus and Giroux. 2009.



## *The Value of Competition*

The argument that competition leads to innovation, efficiency, and lower rates comes from the basic economics principle of supply and demand, which states that increased competition puts downward pressure on cost of goods and services, “reduc[ing] slack, and provid[ing] incentives for efficient organization of production.”<sup>64</sup> In other words, for-profits MFIs have incentives to continuously pursue innovation and efficiency in order to maintain a competitive advantage. That way for-profits are able to decrease organizational costs and thus decrease interest rates.

When the microfinance industry became more commercialized and microfinance for-profit institutions proved themselves to be financially self-sufficient, the sector experienced a flood of new competitors, with many nonprofits shifting to for-profit organizations, being a period “characterized by [...] technology innovation and improvements in methodological risk management.”<sup>65</sup> In terms of lowering interest rates, it is true that interest rates have decreased by “2.3 percentage points a year between 2003 and 2006.”<sup>66</sup> However, many studies show

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<sup>64</sup> Howitt, Peter. “Competition, Innovation and Growth: Theory, Evidence and Policy Challenges.” *OECD-World Bank Joint Conference on Innovation and Sustainable Growth in a Globalized World*. November 18, 2008. <https://www.oecd.org/innovation/41708270.pdf> (accessed April 20, 2017).

<sup>65</sup> Christen, R., Rhyne, E., Vogel, R. “Maximizing the outreach of microenterprise finance: The emerging lessons of successful programs.” 1995. Washington, DC: The Consultative Group To Assist The Poorest; Lowery, Curtis A. “Intention versus Impact: Comparing Interest Rates Charged by Non-profit Organizations and Commercial Banks in Latin American Microfinance Industry.” Order No. 10257984, San Diego State University, 2016. <http://dist.lib.usu.edu/login?url=http://search.proquest.com.dist.lib.usu.edu/docview/1877957586?accountid=14761> (accessed April 20, 2017)

<sup>66</sup> Rosenberg, Rosenberg, Adrian Gonzalez, and Sushma Narain. “Are Microcredit Interest Rates Excessive?” *CGAP*. February 2009. <https://www.cgap.org/sites/default/files/CGAP-Brief-Are->

different results up to this point. Curtis A. Lowery's regression model comparing the different levels of interest rates between nonprofits and for-profits MFIs, for example, suggests that legal nonprofits are likely to charge higher full APR than for-profits in Latin America.<sup>67</sup> Kenneth Downey and Stephen J. Conroy's study suggest that interest rate levels are, on average, the same between for-profits and nonprofits MFIs.<sup>68</sup> On the other hand, interest rates in Bangladesh have had a statistically significant increase since for-profits entered the microfinance sector.<sup>69</sup> Therefore, assuming that competition *always* leads to lower prices - interest rates in this case - is misleading, especially given the early stage of the industry and scarcity of competitors.

It is important to keep in mind that interest rates are a signal of risk to the borrower.<sup>70</sup> The true price of financing (interest rates) is set by the market in the for-profit sector. Interest rates set by for-profits represent the riskiness of one's project - if a project is risky, interest rates are likely to be higher, and vice-versa. Interest rates set by nonprofits sector, however, are distorted, being artificially

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Microcredit-Interest-Rates-Excessive-Feb-2009.pdf (accessed April, 24).

<sup>67</sup> Lowery, Curtis A. "Intention versus Impact: Comparing Interest Rates Charged by Non-profit Organizations and Commercial Banks in Latin American Microfinance Industry." Order No. 10257984, San Diego State University, 2016.

<http://dist.lib.usu.edu/login?url=http://search.proquest.com/dist.lib.usu.edu/docview/1877957586?accountid=14761> (accessed April 5, 2017)

<sup>68</sup> Downey, Kenneth and Stephen J. Conroy. "Microfinance: The Impact of Nonprofit and For-Profit Status on Financial Performance and Outreach." n.d. <https://www.econ-jobs.com/research/35795-Microfinance-The-Impact-of-Nonprofit-and-For-Profit-Status-on-Financial-Performance-and-Outreach.pdf> (accessed April 24, 2017).

<sup>69</sup> Rosenberg, Rosenberg, Adrian Gonzalez, and Sushma Narain. "Are Microcredit Interest Rates Excessive?" CGAP. February 2009. <https://www.cgap.org/sites/default/files/CGAP-Brief-Are-Microcredit-Interest-Rates-Excessive-Feb-2009.pdf> (accessed April, 24).

<sup>70</sup> Blau, Ben. E-mail message to Finance Professor at Utah State University. April 24, 2017.

lower because of subsidies.<sup>71</sup> That is a concern to both the borrower as well as the lender. If interest rates do not properly reflect the level of risk of a particular project, then the likelihood of failure might increase.

### *Larger Population Reach and Ability*

The two main problems with nonprofits in general, many argue, is the dependency of donors and the difficulty of acquiring quick capital. As previously mentioned, most nonprofit MFIs that converted to for-profits did so under the reasoning that for-profits solved both problems. As MFIs have become profitable, so have grown the number of private investors.<sup>72</sup> Furthermore, Dan Pallotta, a board member of Triangle, a center for the developmentally disabled, points out the social innovation problem lead by the stigmatization of nonprofits.<sup>73</sup> He criticizes the misconception that nonprofits should have low overhead costs - usually demanded by donors.<sup>74</sup> This stigma, he argues, discourages investments that could be potentially positive in order for the organization to grow faster, leading to a lack of innovation and less efficiency than for-profits.<sup>75</sup> That means for-profit MFIs are able to meet the high demand for financial services faster than nonprofits could, and until nonprofits gain a greater breadth, being able to serve level 3 and 4 of the world

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<sup>71</sup> IBID.

<sup>72</sup> Canales, Rodrigo, Karlan, Dean and Tony Sheldon interview by Yale School of Management. "What are the Realities of Microfinance?" *Yale Insights*. February 2, 2013. <http://insights.som.yale.edu/insights/what-are-the-realities-of-microfinance> (accessed April 20, 2017)

<sup>73</sup> Pallotta, Dan. "The Way We Think About Charity is Dead Wrong." *TedTalk*. March 2013. [https://www.ted.com/talks/dan\\_pallotta\\_the\\_way\\_we\\_think\\_about\\_charity\\_is\\_dead\\_wrong/transcript?language=en#t-532154](https://www.ted.com/talks/dan_pallotta_the_way_we_think_about_charity_is_dead_wrong/transcript?language=en#t-532154) (accessed March 20, 2017).

<sup>74</sup> IBID.

<sup>75</sup> IBID.

economic pyramid, nonprofits MFIs will remain the best option for serving their current target audience.

### *The Ends Justify the Means*

The third main argument in defense of for-profits MFIs counter argue Immanuel Kant's moral principle with consequentialist moral principles of ethics of responsibility, preached by John Stuart Mill, a 19th century English philosopher. Mill holds that "morality is all about producing the right kinds of overall consequences."<sup>76</sup> The point of morality, therefore, is to bring the most utility (some kind of benefit to the highest amount of people). In the case of microfinance, consequentialism defends that profit motives do not define whether an action is ethical or not - the outcome does. In fact, if microfinance for-profits are able to have a larger and better impact on a higher amount of people.

Studies show that for-profits MFIs do a better job at reaching more people (breadth).<sup>77</sup> However, they also show that for-profits have less depth of outreach. Measuring which one, breadth or depth, provides the highest utility, however, is a difficult.<sup>78</sup> Thus, the moral argument, for nonprofits and for-profits, will remain a challenge and part of the ongoing debate.

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<sup>76</sup> Haines, W. "Consequentialism." *Encyclopedia of Philosophy*. (n.d.). <http://www.iep.utm.edu/conseque/> (accessed March 20, 2017).

<sup>77</sup> Louisa, Philippe and Bart Baesensa. "Do for-profit microfinance institutions achieve better financial efficiency and social impact? A generalized estimating equations panel data approach." <https://umsbe.wufoo.com/cabinet/m7z8a3/9WfMwqwuBeDmms%3D/text.pdf>.

<sup>78</sup> IBID.

## CONCLUSION

After discussing the history, different markets, technicalities, and debate surrounding microfinance nonprofits and for-profits, let's review the findings.

In the late 1900's, Muhammad Yunus developed the microcredit model with the objective of combating predatory lending and helping the poor help themselves out of poverty through entrepreneurship. Within three decades, the microcredit movement emerged. Due to its popularity, some nonprofit microcredit institutions transitioned to the private sector in order to raise capital faster. As the ability to generate a profit in the microcredit sector was identified, new for-profits MFIs entered the market, offering more than microcredit services and giving birth to the microfinance.

Although co-existing in the same sector, microfinance nonprofits and for-profits seems to be serving different markets. Nonprofits focus on the poorest of the poor and the poor. They serve the very bottom of the world economic pyramid, in term of income. In addition, they focus on decreasing risk of default, tending to be more careful in the selection process of prospect loan recipients. For-profits MIFs, on the other hand, focus on those who suffer from financial exclusion, social and political exclusion, and marketing exclusion, consisting of the unregistered, the disadvantaged and the marginalized, respectively. They tend to focus on profits, having a larger clientele and accounting for financial risks through higher interest rates.

When looking at nonprofits and for-profits in general, the two main

differences lie within legal and regulatory terms and sources of funding. They can also overlap once corporate social responsibility, B-corps, and Benefit Corporations are taken into account. Taking a micro-view standpoint, the microfinance model tends to change between informal, semi-formal, and formal microfinance institutions. Informal and semi-formal institutions - mainly consisting of individuals and nonprofits - usually provide microcredit services and training to beneficiaries. Formal institutions, or for-profits, provide financial services in addition to microcredit, such as checking and savings accounts.

The debate becomes heated due to three arguments against for-profits MFIs. The first argument is that profit motives do not align with social goals, since higher interest rates are desired in order to increase profits. The second argument is that profit motives lead to imprudent lending and irresponsible borrowing, which causes beneficiaries to fall into debt traps. The final argument is that it is unethical wrong to profit from the poor, following Immanuel Kant's moral principles.

The proponents of for-profit microfinance organizations take a stand to show benefits of offered by the private sector and free market. The first argument defending for-profits MFIs focus on the efficiency of the market because of competition. They argue that competition will lead to innovation, efficiency, and lower interest rates. The second argument is that through privatization, for-profits are able to get the funds needed to serve the high demand for microfinance services at a faster pace than nonprofits can. Thus, they are able to reach a bigger pool of clients. Finally, the third argument is a rebuttal to Immanuel Kant's moral principle of intention with Stuart Mill's moral principle of outcomes. They argue that

intentions do not matter as long as they are more efficient than nonprofits at benefiting the largest number of people.

In conclusion, some for-profit microfinance organizations might be indeed exploiting their target market. However, as of right now, they are serving a market that nonprofits are incapable of reaching, and until nonprofits are able to gain greater breadth, for-profit MFIs will remain the best ones at doing so. If or when nonprofits are able to find better ways of funding, they might be able to also reach the upper level 3 and the bottom level 4 of the world economic pyramid, putting downward pressure on interest rates.

Furthermore, competition can also help interest rates go down, making microcredit services more affordable. Up to this point, competition has not exactly followed the economic model of perfect competition. Interest rates varied greatly, increasing in some regions and increasing in others. As interest rates are a risk-of-default measurement, it could be that certain regions have become more risky than others. Another explanation is that the microfinance industry is not yet saturated for competition to make a significant impact. Either way, increasing competition is in the best interest of the beneficiaries.

## **REFLECTIVE WRITING**

During my internship in Trujillo, Peru, through the SEED Program, I was able to have a first-hand experience with microfinance department within a corporation. From September 2016 to December 2016, I served as a business consultant and a teacher to aspiring Peruvian entrepreneurs that lived under the poverty line. With time, I started noticing how the majority of beneficiaries were having a hard time keeping their business going, while two or three were being successful. As I conducted primary research on each of my clients, I became more and more curious about the effectiveness of microfinance organizations.

Once back to the United States, I decided to seek further understanding of the microfinance industry and its effectiveness to this day. My first research question was: are microfinance organizations effective in alleviating poverty? As my research evolved and I noticed the differences between nonprofits and for-profits MFIs, my research question transformed into: are microfinance for-profit organizations more effective than nonprofit in alleviating poverty? As I encountered limited data on the numbers of successful and unsuccessful beneficiaries of microfinance organizations as well as difficulty in measuring efficiency, my research question finally became: should the microfinance sector only be served by nonprofit organization?

My capstone thesis attempts to answer this question through objective lenses. The research was focused on the main arguments for and against for-profit organizations, seeking to uncover misconceptions. Overall, my research process took months before I reached my final research questions. Although no as data intensive, my final project is the first step needed before I can look further into microfinance efficiency in the future.



## **AUTHOR BIO**

Hane de Oliveira Crevelari, a native Brazilian and an economics enthusiast, received her Baccalaureate of Science in International Business and Economics in May of 2017. While in college, Hane was extremely involved, being a Huntsman Scholar, a Koch Scholar, the secretary for the Society for International Business and Economics Development, a SEED Intern, and a Business Ambassador. Hane will be interning with the U.S. Senate Committee on Finance in Washington, D.C., under the international trade team the summer of 2017. With a strong international focus, Hane aspires to remain working with international trade in the near future, with a long-term goal of pursuing a MBA and a Ph.D. in Economics.